Lots to lose if investors risk it all on problem products

Look before you leap into deals promising capital-protected investments, writes **David Huggins**

Some financial products have been sold by financial planners to clients as being capital protected or capital guaranteed.

How they work is that the client borrows money from the promoter of the product on the basis that when the product matures they are guaranteed to receive enough money to pay back the loan. This sounds like a great deal but for a number of reasons it isn't and many clients have had disastrous outcomes as a result of investing in these products.

There are many problems with these products but I will just discuss some of the worst.

The first is that clients can suffer a loss from their investment.

While the capital component of the loan is guaranteed the interest component is not. This means that if the product does not generate income that is greater than after-tax interest that is payable on the loan, the client will make a loss.

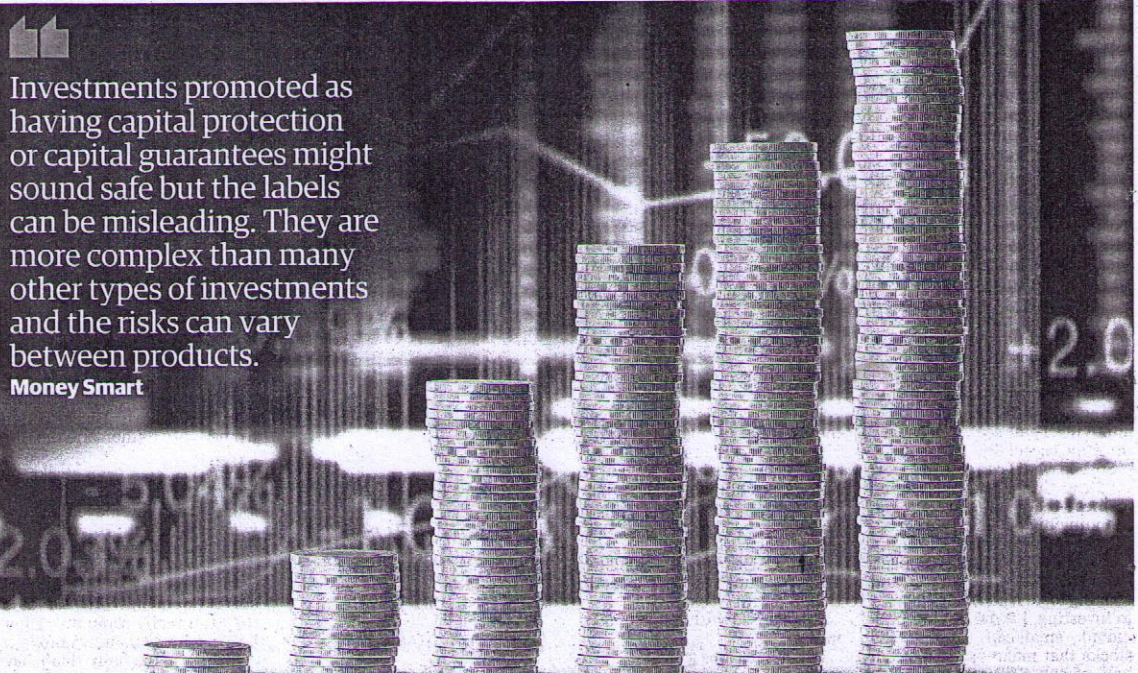
This problem is made worse for two reasons.

First, some clients take out very big loans to make these investments because they think they can't make a loss. This exposes them to the risk that they will make very big losses should the product not perform as expected.

Second, the interest rates associated with these loans are high as they reflect the costs incurred by the promoter in offering capital protection. Again, this means that potential losses can be very high but it also means the likelihood that an investor will make a profit from this type of investment is much lower.

Another problem is that the products involve a fixed obligation to make loan repayments over a number of years.

If you borrow to invest to buy shares and the investment performs poorly, or for some other reason you no longer wish to invest, you can sell the shares and pay out all or part of the loan. But this is not how these products work.



COSTLY COVER

MIXED BAG
Structured products promoted as having capital guarantee or capital protection typically combine a safe and a risk asset into one product structure.

RISKY CONFUSION
Capital guaranteed and capital protected structured products should not be confused with more conservative investments that may also be described as 'protected' or 'guaranteed'.
This includes life insurance annuities, savings accounts and term deposits with an federally regulated bank, building society or credit union.

DO YOUR HOMEWORK
The labelling or description of these structured products can create a perception of safety that, in some cases, is inconsistent with the product's features and risks. There are often significant qualifications and conditions associated with the 'guarantee' or 'protection'.

NO FREE LUNCH
With capital guaranteed and protected products, higher promised returns usually come with higher risks.

DECISION TIME
Even if you are confident of the security of the guarantee or protection, you need to weigh up the cost of the product against the benefits it can provide.

Source: moneysmart.gov.au

Once you take out the loan you must pay the interest on a fixed schedule for the entire life of the product and if you can't or don't the only way you can get out of this obligation is by paying very substantial "break fees".

The third problem is that given the size of the loans many investors are dependent upon income received from the product to pay the interest on the loan.

However, once investors lock themselves in to making interest repayments they find out the income actually paid by the product is far less than they expected or might even be nothing — becoming "cash locked".

These investors then have to try to fund what are often very big interest payments from other sources.

The fourth problem is that these products are complex and operate over a number of years. This means it is very difficult to predict how much income will be generated over the life of the product and what return will be received when the product matures.

This is a major issue because by taking out a loan to buy these products the investor is locking in to making substantial interest repayments in circumstances where it is impossible to be reasonably sure that enough income will be received to help service the loan. It is also impossible to be reasonably sure that the end return will be greater than the net interest paid on the loan.

Despite these obvious problems these products have been sold by financial planners to their clients and clients have suffered enormous losses. In some cases the advice provided about these products to clients has been grossly deficient for two reasons.

First, clients were not warned about the risks associated with these products. Many clients heard the words "capital guaranteed" or "capital protected" but didn't understand this did not prevent them from suffering a loss. If they had understood the limits of what capital protection actually offered, they would not have invested.

Second, clients were only shown one set of often overly optimistic projections about how these products would perform in circumstances where it was impossible to make any sensible predictions.

If clients had seen less optimistic projections they would have realised they were taking on the risk of making substantial losses and would not have invested in these types of products.

David Huggins is a lawyer who specialises in resolving disputes about poor financial advice